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SUBJECT: MOFCOM TO SPECIAL REPRESENTATIVE MERMOUD: MERGER
RULES IN LINE WITH LIBERALIZATION

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SUMMARY

1. (SBU) China's proposed merger and acquisition (M&A) rules do not signal a shift in attitude towards foreign investment, according to the Ministry of Commerce (MOFCOM) Director General (DG) in charge of the drafting process, who met on August 28 with EB/CBA Mermoud. The DG argued that China, as an economy in transition, needs to regulate and supervise how the assets of state-owned enterprises (SOEs) are valued when such assets are sold off as part of privatization. END SUMMARY

MEETING DETAILS

2. (U) Special Representative for Commercial and Business Affairs Frank Mermoud met on August 28 with PRC Ministry of Commerce Department of Treaty and Law Director General Shang Ming and Deputy Director Wen Xiantao. The central focus of the meeting was draft merger and acquisition (M&A) rules made public by the Chinese government on August 8.

BACKGROUND ON THE PROPOSED M&A RULES

3. (U) The Ministry of Commerce (MOFCOM), together with the State Administration of Foreign Exchange (SAFE), the State Administration for Taxation, the State Administration of Industry and Commerce, the China Securities and Regulatory Commission (CSRC), and the State Owned Assets Supervision and Administration Commission (SASAC), promulgated the "Measures on Acquisitions of Domestic Enterprises by Foreign Investors" to replace the "Provisional Measures on Acquisitions of Domestic Enterprises by Foreign Investors" that have been in effect since April 2003. The draft rules, released on August 8, are to become effective on September 18.

4. (U) According to an analysis prepared by the law firm Paul Hastings, the proposed rules expand the original 26 sections to 61 sections, and further organize the 61 sections into six articles. The proposed rules strengthen MOFCOM's supervisory role, in part by requiring its approval in the following areas:

-- restructuring activity of Chinese businesses offshore

- acquisitions where the acquirer would:
 - o control an enterprise in an "important industry";
 - o control an enterprise that owns "famous trademarks" or "well-known Chinese trade names"; or gain the ability to affect "China's economic security".

¶5. (U) The proposed rules also provide for "equity swap" and thus allow for the following cashless transactions:

- corporate restructures for initial public offerings in foreign exchanges; and
- acquisitions by foreign listed companies using their own shares.

CONCERNS, CONFUSION, AND A NEED FOR CONSULTATION

¶6. (SBU) Mermoud observed that the draft M&A rules have caused concern and confusion in the foreign business community. AmCham and industry representatives had complained to him about insufficient opportunities to provide input during drafting. Mermoud emphasized the importance of clear and transparent regulations as well as a follow-up process that enables those affected by the rules to truly understand their meaning. He also asked specific questions about various draft articles.

POSITIVE SPIN...

¶7. (SBU) DG Shang said the goal of the rules is to provide a new legal channel for domestic entities to strengthen themselves, including by listing in foreign locations. Shang said the draft rules are not really new but should

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instead be understood as a revision of those that came into effect in 2003. The changes are being made in a context of continued opening and reform by the PRC. There has been no change in attitude towards foreign investment, press and media commentaries about "unrelated" acquisition cases (presumably CNOOC and Lenovo) notwithstanding.

... AND A CLAIMED POSITIVE RESPONSE

¶8. (SBU) Shang said the PRC reached out for comments from Chinese government ministries, foreign investors, and foreign governments. The response from "society" to the draft has been positive. He acknowledged that there had been some questions and confusion -- it is a long and hard to understand document -- but asserted that MOFCOM is working to improve understanding of the draft. According to Shang, the PRC does not wish to place new burdens or restraints on investors.

IN LINE WITH INTERNATIONAL PRACTICE

¶9. (SBU) Shang underscored China's focus on compliance with WTO commitments and desire to operate in line with international practice. He acknowledged outside concerns about "economic security" references in the draft rules, a concept he asserted as also in line with the policies of other countries. The reference to economic security not only pre-dates the recent draft revision but is also embedded in United States and European Union policies and practices. The fundamental issue, according to Shang, is how the national economy operates in people's lives.

VALUATION ISSUE

¶10. (SBU) Shang, noting that China still regulates the

movement of capital into and out of the country, said it is important for ministries and agencies to pay attention to the prices that SOE managers attract for state assets when they are privatizing, a process that must be supervised. Certified Public Accountant (CPA) firms under Ministry of Finance (MOF) supervision and "evaluation associations" will play a key role in ensuring that prices set are in line with actual value. CPA firms that cheat will be brought to MOF's attention. The overall goal is to make transactions fair. This process will be about credibility and good faith, according to Shang.

OTHER AREAS OF SIGNIFICANCE

¶11. (SBU) Referring to restrictions involving ownership of brands and trademarks, Shang said that there are many traditional brand names and special techniques from Chinese history that are to be protected, and that this is a part of maintaining China's heritage.

¶12. (SBU) Shang said that one significant change in the new draft is the use of stock as payments for M&A, an approach that will lower the cost of funds to domestic enterprises. In Shang's view, it is domestic entities rather than foreign investors that will be most affected by the changes, especially those entities that move funds offshore into "special purpose vehicles" and then invest those funds back into China (Note: "round-tripping," a practice often motivated by tax and other legal considerations. End Note).

COMMENT PERIOD

¶13. (SBU) Responding to suggestions from Mermoud, Shang said it is not possible to extend the commentary period for the rules (Note: The rules become effective September 8. End Note.) because six ministries were involved in setting up the timetable. Shang did however agree to Mermoud's request that he accept a list of questions from the Embassy in order to provide further clarification about the draft rules in advance of their coming into force.

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